

STATEMENT BY PREMIER LOUGHEED
AND ENERGY MINISTER JOHN ZAOZIRNY

on

OIL AND GAS INCENTIVES

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ALBERTA'S OIL AND GAS INCENTIVES

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The Alberta Oil and Gas Activity Program, announced on April 13, 1982, implemented major changes to Alberta's oil and gas royalty system and associated incentive programs and has contributed significantly to a steady upswing in oil and gas activity in our Province in the aftermath of the unilateral imposition of the devastating National Energy Program. Drilling activity has increased, significant new reserves of crude oil have been found, and several commercial oil sands and heavy oil projects are in the implementation or early production stages. Overall, in spite of uncertainties over markets and prices, the Alberta-based oil and gas industry is in the process of making a remarkable comeback from the circumstances which prevailed a few years ago.

Since the Oil and Gas Activity Plan was implemented in April, 1982, other important events have occurred, which have had or will have a significant bearing on the prospects for continued oil and gas development in our Province. In September, 1982, the Alberta government announced changes to incentives for enhanced recovery of crude oil, which subsequently have generated major new investments and increased activity in the older oil-producing areas of the Province. In June, 1983, the Alberta and federal governments signed an Amending agreement on oil and gas pricing that provided "new oil" prices to a significant volume of existing production and thus enhanced producer cash flows.

On the natural gas side, in July, 1984, the federal government, in consultation with the producing provinces and industry, established a more market-oriented gas export policy. This move came at a time when export gas sales were slumping at an alarming rate and allowed Canadian sellers and their producers the flexibility in contract negotiations to retain and expand U.S. markets over time. Consequently, although prices to U.S. purchasers are necessarily lower than the regulated levels, volumes have increased substantially and vital producer cash flows have been maintained.

More recently, on March 28, 1985, the Western producing provinces and federal government announced the Western Energy Accord, which among other matters provided for decontrol of Canadian crude oil prices on June 1, 1985. Equally important, the Agreement also provides for the elimination or phasing out of certain federal taxes and incentives, including the onerous Petroleum and Gas Revenue Tax (PGRT). Removal of these federal taxes will have an immediate and longer term beneficial effect on industry cash flows and activity levels in the overall.

Notwithstanding the distinctly positive thrust of the Western Energy Accord, other events taking place outside our borders can effect industry's plans and activity levels in Alberta and other parts of Canada. Principal among these factors is continuing fragility of international oil prices, caused by a current imbalance in world supply and demand for petroleum products.

Another important factor is U.S. natural gas markets. Overall, gas supply potential still exceeds demand, and recent actions by U.S. federal regulatory agencies have led to increased competition among potential suppliers, including Canadian suppliers, for a share of the U.S. marketplace. In the longer term, however, the prospects for expanding Alberta gas sales in the U.S. market are excellent.

This, then, is the basic background against which the government has carried out its review of incentive programs and other factors that may influence the prospects for continued development of Alberta's oil and gas resources. Considerable progress has been made over the past four years in achieving Alberta's goal of market value for depleting resources, culminating in crude oil decontrol on June 1st of this year.

At the same time the dismantling of the maze of special federal taxes and regulatory constraints on the Western Canadian petroleum industry has been set in motion. Against these trends, international crude prices are uncertain and similar pressures on gas prices are evident in U.S. export markets. Yet, the longer term picture for the development of Alberta's conventional petroleum and oil sands resources is still remarkably good, with sound opportunities for the astute investor, large or small.

In keeping with the spirit of the Western Energy Accord, and with the objective of maintaining a strong and active oil and gas industry in our Province, the Government has thoroughly reviewed its existing incentives to the oil and gas industry

and is implementing a number of significant changes to the existing royalty and incentive systems. These changes will ensure that the benefits of the deregulation of crude oil pricing are flowed through to the industry and will deliver the benefits of current incentive programs in a more effective manner suited to changed industry circumstances. These changes not only will enhance the cash flow of companies or investors with existing production but also will improve the economics of new oil and gas development.

Oil and Gas Royalties

Commencing August 1, 1985, marginal royalty rates on both old and new oil and natural gas will be reduced in stages over a 24-month period from 45% to 40% on old production and from 35% to 30% on new production. The reduced rates will be phased in according to the following schedules:

<u>Period</u>	<u>Old Oil & Gas Marginal Rate</u>	<u>New Oil & Gas Marginal Rate</u>
Aug. 1/85 - July 31/86	43.5%	33.5%
Aug. 1/86 - July 31/87	42.0%	32.0%
Aug. 1/87 onward	40.0%	30.0%

The net effect of these changes will be to enhance the cash flow of all companies and individual investors with income from existing oil and gas production. In addition, the reduction in new royalty rates will improve the economics of finding new and increasingly costly reserves of conventional oil and gas in Alberta. The reduction in new rates also will further improve the economic attractiveness of costly enhanced recovery projects, directed toward more efficient recovery of reserves in existing oil pools.

Based on price and production levels commensurate with current industry conditions and current exchange rates, the adjustments in royalty rates, when fully implemented, will enhance the producing industry's cash flow by approximately \$550 million per year.

Royalty Tax Credit

The Royalty Tax Credit to small producers will be increased effective April 1, 1986, from its current level of 50% of royalty obligations to a maximum of \$2 million per eligible company or investor to 75% of royalty liabilities to a maximum of \$3 million per eligible company or investor. The enrichment of this program will coincide with the effective termination of the Alberta Petroleum Incentive Program (APIP), which has provided cash grants to Canadian companies and investors in support of exploration and development expenditures in the Province. In maintaining and enriching this program, the Government recognizes the increasingly important role played by small producers and individual investors in finding and developing our Province's conventional oil and gas resources.

It is estimated that the incremental value to producers of enriching the Royalty Tax Credit Program will be approximately \$115 million per year at current price and production levels.

Incentive Programs

The Government has completed its review of existing incentive programs, taking into account the numerous submissions received from industry associations and individual companies. The consensus among industry spokesmen is that the existing grant-oriented programs, which tend to favor mere activity, should be replaced by a new system of royalty holidays, which rewards the successful explorer. This approach has the backing of the majority of producers and the drilling and associated service companies, whose economic well-being depends on the level of producer activity.

In keeping with these recommendations, the Government proposes to phase out or terminate the various incentive grant programs and replace them with an enhanced system of royalty holidays:

(a) Alberta Petroleum Incentive Program (APIP)

The Alberta Petroleum Incentive Program (APIP) has provided since 1981 approximately \$450 million annually in the form of cash grants to eligible Canadian companies in support of exploration and development work carried out in Alberta. APIP will be terminated on March 31, 1986, nine months prior to the termination date specified in the September, 1981 Canada/Alberta Energy Agreement. Work eligible for APIP grants must be commenced and completed prior to April 1, 1986, although certain activities will be "grandfathered" to December 31, 1986 in accordance with guidelines now under consideration by the Department of Energy and Natural Resources. The guidelines will be drawn up in consultation with industry.

It is recognized that the phasing out and final wrap-up of certain aspects of the program may take an additional 18 to 24 months beyond APIP's termination date.

(b) Other Grant Programs (EDIS, GIS)

Regulations covering the existing Exploratory Drilling Incentive System and the Geophysical Incentive System will be allowed to expire on July 31, 1985.

A new regulation extending the existing EDIS royalty holiday for new natural gas exploratory wells will become effective August 1, 1985.

(c) **New Crude Oil Royalty Holiday Program**

The existing provisions for crude oil royalty holidays, authorized under the Exploratory Drilling Incentive System (EDIS) and Oil Royalty Exemption System (ORES) will expire on July 31, 1985. They will be replaced by a new crude oil royalty holiday system effective June 1, 1985, that will apply to all new conventional crude oil wells drilled outside existing pool boundaries (as defined by the Energy Resources Conservation Board) on or after June 1, 1985. So-called "off target" wells drilled on or adjacent to existing pool boundaries and wells drilled to produce crude bitumen from oil sands leases will not be eligible for the benefits of the new program.

The royalty holiday will consist of the greater of:

- (1) A 12-month royalty-free period for each eligible well to a maximum of \$1 million per well; or
- (2) A royalty exemption defined as a volume of crude oil for each eligible well, calculated from a depth-related schedule appended to this announcement. The schedule takes into account variations in average drilling costs among the different areas of the Province and, in general, accounts for approximately 35% of industry average drilling costs in each geographic region.

Wells drilled into the more productive pools undoubtedly will achieve the \$1 million maximum benefit prior to the expiry of the 12-month royalty-free period. Low productivity wells, on the other hand, will continue to produce royalty-free oil beyond the 12-month period until the cost related volume specified by the attached schedule is attained.

The program will be effective for a period of 3 years, from June 1, 1985 to May 31, 1988. During the two-month period June 1-July 31, 1985, when the EDIS and ORES regulations are still in effect, a producer may elect to apply for either of the existing royalty holiday benefits (should the well in question be eligible under the existing regulations) or for the benefits under the new program.

Annual benefits of the new crude oil royalty holiday program will be approximately \$525 million, as determined from current finding and production rates for new pools.

(d) Natural Gas Royalty Holiday Programs

The current status of natural gas markets, including the large volumes of shut-in gas, makes it difficult to expand the existing natural gas royalty holiday system (under the EDIS regulations) without a marked impact on Crown royalty revenues. Nonetheless, the Government recognizes the need to maintain a reasonable level of exploration activity for new gas reserves, in anticipation that the market situation will improve very significantly later in this decade. Taking these circumstances into account, the Government has decided for the time being to retain the existing 12-month royalty holiday program for exploratory natural gas wells, and to implement a supplementary royalty holiday program for deep gas drilling.

The existing natural gas royalty holiday is authorized under the EDIS regulations and provides for a 12-month royalty-free period for an eligible exploratory well to a \$2 million maximum per well. The EDIS regulations will expire

July 31, 1985, but a new regulation extending the natural gas royalty holiday provisions of the existing program will become effective for the period August 1, 1985 to May 31, 1988. The new regulation will define the royalty holiday for exploratory wells as the greater of:

- (1) A 12-month royalty-free period for each certifiable well to a maximum of \$2 million per well; or
- (2) A royalty exemption defined as a dollar amount applied against royalties payable from the sale of natural gas and products from a certifiable exploratory well, calculated from a depth-related schedule appended to this announcement. This schedule takes into account variations in average drilling costs among the different areas of the Province.

In addition, a new royalty holiday program will be implemented for deep gas wells, effective June 1, 1985. The holiday will apply to all new wells drilled into new gas pools or into extensions of existing pools (as defined by the Energy Resources Conservation Board as of June 1, 1985) located below depths of 2500 metres (approximately 8000 feet). The royalty holiday will be defined in terms of a dollar amount applied against royalties payable from the sale of natural gas and products from an eligible well, which increases with well depth and hence the cost of incremental drilling below 2500 metres. A sample schedule showing the relation of well depth to the proposed royalty dollar exemption is appended to this announcement.

In implementing this program, the Government recognizes the need to accelerate the search for the deeper and more costly gas reserves of the Alberta Sedimentary Basin. This is the

area where much of our future gas supplies will come from, and the finding and development of these supplies will require long lead times and, in many cases, construction of costly gathering and processing facilities.

The long-term benefit of the new program to the gas exploration industry is difficult to assess at this point. In the shorter term, within the next year or two, the benefits are estimated at \$100 million per year.

Benefits of the New Incentives

The benefits to industry of the changes to the Crown's royalty and incentive systems can be estimated on a fully implemented basis as follows:

<u>Current System</u>		<u>New System</u>	
(\$ Millions per annum)			
EDIS Grants	100	Oil Royalties	350
GIS Grants	120	Gas Royalties	200
APIP Grants	450	Royalty Tax Credit	115
EDIS Oil Holiday	100	Oil Royalty Holiday	525
ORES Oil Holiday	100	Deep Gas Royalty Holiday	100
EDIS Gas Holiday	<u>140</u>	Gas Royalty Holiday	<u>140</u>
	\$1010 Million		\$1430 Million
		Less	\$ <u>1010 Million</u>
		Difference	\$ 420 Million

The estimates are based on price and production levels commensurate with current conditions and, in the case of incentive programs, on current activity levels and discovery rates. When the new programs are in place fully, industry's cash flow will be enhanced by approximately \$400 million annually. This is in addition to the significant gains in aggregate cash flow

that arises out of crude oil deregulation. At the same time, with the full implementation of these incentives and a full phase out of the former incentives, it is anticipated that there will be no material impact on Alberta Government aggregate revenues from what they would otherwise have been prior to deregulation, having regard to the anticipated revenues from the sale of petroleum and natural gas rights.

These funds will be spread across the entire spectrum of the producing industry in Alberta, with significant benefits flowing to the associated geophysical, drilling and well service industries. The Government believes the distribution of these benefits not only will improve investor confidence in Alberta's oil and gas industry, and thereby enhance existing activity levels, but also will serve to bolster the continuing recovery of the Province's economy as a whole.

With a prosperous and active oil and gas industry, all Albertans and ultimately all Canadians stand to benefit in terms of increased employment and generation of goods and services.

CRUDE OIL ROYALTY INCENTIVE SYSTEM

Cumulative Barrels of Exempted Royalty Oil per Eligible Well

<u>Producing Depth (metres)</u>	<u>Northern-Foothills</u>	<u>Central</u>	<u>Plains</u>
0	0	0	0
500	1,750	900	700
1000	3,600	1,800	1,500
1500	5,800	3,300	2,600
2000	8,500	4,800	3,900
2500	11,200	7,600	5,400
3000	15,500	10,700	7,000
3500	20,400	15,600	8,750
4000	25,700	19,900	10,500

1. "Cumulative Barrels" specifies the amount of royalty oil exempted from payment under The Petroleum Royalty Regulations. "Producing Depth" refers to the base of the deepest producing zone within an eligible well.
2. The \$1 million maximum royalty exemption applies to all wells.

NATURAL GAS EXPLORATORY WELL INCENTIVE SYSTEM

Cumulative Value (\$000) of Royalty Exemption per Eligible Well

<u>Producing Depth (metres)</u>	<u>Northern-Foothills</u>	<u>Central</u>	<u>Plains</u>
0	0	0	0
500	60	30	30
1000	130	70	60
1500	210	120	100
2000	300	180	150
2500	400	270	200
3000	560	380	250
3500	740	560	310
4000	930	720	380

1. "Cumulative Value" specifies the dollar amount that may be applied against royalties on natural gas and gas products payable under The Natural Gas Royalty Regulations. "Producing Depth" refers to the base of the deepest producing zone within an eligible well.
2. The \$2 million maximum royalty exemption applies to all wells.

NATURAL GAS DEEP WELL INCENTIVE PROGRAM

Cumulative Value (\$000) of Royalty Exemption per Eligible Well

<u>Producing Depth (metres)</u>	<u>Cumulative Value</u>
2500	0
3000	500
3500	1,000
4000	1,500
4500	2,150
5000	2,800
5500	3,550

1. "Cumulative Value" specifies the dollar amount that may be applied against royalties on natural gas and gas products payable under The Natural Gas Royalty Regulations. "Producing Depth" refers to the base of the deepest producing zone within an eligible well.